THE TAXATION OF CO-OPERATIVES PAST, PRESENT AND FUTURE

by E.F. Mannix LLB., F.C.A.A.

Taxation Consultant Co-operative Federation of Australia

The taxation of co-operatives in the major countries of the world is on a basis somewhat more advantageous to such companies than are the normal provisions of the law relating to the taxation of companies. In many respects one must assume that this is merely a reflection of the generally accepted view that one cannot make a profit out of dealing with oneself, in other words the mutual concept applicable to income tax liabilities has been extended marginally into the co-operative company field. In Australia, in particular, the marginal test is quite strict in that it requires what in effect is 90% mutuality and narrows the possible extension of business activity in a way which is illustrated by a number of court and Board of Review decisions which will be referred to later.

The Australian income tax law provisions relating to co-operatives refer only to 5 specific types which are referred to in Section 117 of the Income Tax Assessment Act and in particular there are some notable absentees in fields relating particularly to finance, such as lending facilities, except for the specific class referred to in paragraph (e) of Section 117, insurance facilities, etc. In considering the application of the Australian law to the taxation of a co-operative it is necessary to have regard firstly to the particular provisions of Section 117, notably the limitation on the number of shares which is required to be quite specific and apply to all shareholders (See 11 C.T.B.R. Case 115). In addition, the company's rules must prohibit the quotation of the co-operative's shares on any stock exchange or in any public manner. This limitation has also been interpreted as requiring a specific denial of this right in the company's rules. It is not a compliance with the law for a co-operative to merely pass a resolution at a meeting of members (See 1 C.T.B.R. (N.S.) Case 51).

The types of businesses which may be carried on by a co-operative to qualify for the deduction provided by Section 120 of the Income Tax Assessment Act are set out in 5 paragraphs of Section 117. These read as follows:-

(a) the acquisition of commodities or animals for disposal or distribution among its shareholders;

(b) the acquisition of commodities or animals from its shareholders for disposal or distribution;

(c) the storage, marketing, packing or processing of commodities of its shareholders;

(d) the rendering of services to its shareholders;

(e) the obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business.

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Substantially the tests provided in the 5 paragraphs of Section 117 apply in areas where government intervention is most prominent. Orderly marketing arrangements, control of finance for homes and primary production are areas in which government control has been deemed necessary to ensure the proper conduct of such businesses. This control has resulted, as many of you will be aware, in the interposition of statutory bodies between the co-operative and its shareholders. There are numerous areas in which this control takes place and one example was the constitution of the Milk Board under the New South Wales Milk Act to acquire milk produced by dairy farmers in certain proclaimed areas. The physical acquisition of the milk was still carried out by the co-operative, but the legal title passed from the shareholder to the Milk Board and then to the co-operative in turn. The Commissioner of Taxation took the view that in the circumstances the co-operative had not acquired the product of its shareholders as required by paragraph (b) of Section 117. Fortunately, this view was over-ruled by Board of Review No. 1 in 13 C.T.B.R. (N.S.) Case 100 and the Commissioner of Taxation has seen fit to continue to follow the principle enunciated by the Board in reading the term "acquired" in a commercial rather than a strictly legal sense. Many co-operatives have benefited from this interpretation of the law which, with respect, must surely have been the intentions of the framers of the legislation.

The provisions of Section 117 are qualified by Section 118 in that to qualify for the deduction under Section 120 it is necessary that a co-operative company claiming the deduction should comply with the requirement that 90% of its business should be conducted with its shareholders. It is in this area that a number of co-operatives have run into difficulties in that business activities which have been held to be primary objects have not complied with the necessary percentage requirement, although what one might claim to have been the primary object does in fact comply. Two notable cases have resulted from this interpretation of the Section and in 8 C.T.B.R. (N.S.) Case 80 the Board of Review held that each activity of the co-operative concerned in that case had to satisfy the tests of Section 118 individually and failure to comply in one respect caused the company to fail the tests and cease to be entitled to the deduction under Section 120. This decision was followed by a decision of the High Court in Renmark Fruit Growers Co-operative Ltd. v. Federal Commissioner of Taxation (1969), 1 A.T.R. 385. In that case the Court took a similar view to that adopted by the Board of Review in the case quoted and held that certain activities related to the supply of merchandise to customers must satisfy the requirements of Section 118 before the company was entitled to the deduction under Section 120.

What is a primary object of any co-operative must be essentially one of degree and whilst certain levels of activity could well be substantial in one case they may be considered to be insignificant in other cases. In both the cases referred to where adverse decisions to the co-operative were given the activity in the area in which the company failed was significant in relation to the overall business activities. There were in 13 C.T.B.R. (N.S.) Case 100, certain extraneous activities but these, in relation to the overall business of the co-operative concerned, were insignificant. It is of considerable importance that Section 117 refers to "object or objects" and quite clearly a co-operative can have two or more "primary objects". In addition, in determining whether a company meets the tests of Section 117 a business activity which has been taken into account in determining whether one test is met does not also need to be taken into account in determining whether a second test is met. (per Mr. R.E. O'Neill in 13 C.T.B.R. (N.S.) Case 100 at pp. 698/699). Thus a co-operative which buys product from its shareholders and product from outside merchandisers for sale to its shareholders can, if it meets the overall test of 90% of its total purchases, including those from outside merchandisers, being from shareholders, qualify under paragraph (b) of Section 117 and is not required in respect of the purchases from outside merchandisers to meet the additional test provided by paragraph (a) of Section 117.

is total test could not be met by either of the co-operatives concerned in 8 C.T.B.R. (N.S.) se 80 or Renmark Fruit Growers Co-operative Ltd. v. Federal Commissioner of Tax-on (Supra).

addition the activity carried on must be a primary object and as stated above it appears me that this is a question of degree. The primary object must be one which is established part of carrying on a business and it is of some significance that certain activities such investment in companies, the lending of money, except in the case of money lenders, and renting of properties do not constitute the carrying on of a business. For this reason it uld appear that where there is a major activity which may destroy the co-operative status of ompany consideration could be given to the formation of a separate company to conduct t particular part of the business. Such a business activity removed from the co-operative ıld well leave it with the advantages available to the co-operative in respect of the major ects of its original constitution.

addition to the merchandising activities of certain co-operatives, provision is made for those olved in certain activities related to the rendering of service either as such or the lending moneys to shareholders for specific purposes. It has been held that the taxation of mutual urance companies is not covered by these particular provisions (See Employers Mutual lemnity Association Ltd. v. Federal Commissioner of Taxation (1943), 2 A.I.T.R. 502). the case of companies engaged in the lending of money similar provisions apply but in nsidering such activities one must have regard to the decision of the High Court in vesby Credit Union Co-operative Ltd. v. Federal Commissioner of Taxation (1964), 9 I.T.R. 459, where the High Court held that a credit union qualified as a co-operative der the provisions of the Income Tax Assessment Act not because of the nature of its ual business activities but because of the extra-curricular activities of the group in viding advice, facilities for consultation and to doing of specific acts of assistance. In lition, McTiernan J., who decided the issue in favour of the co-operative, took the view t the favourable rates of interest, lack of regard for securities, etc., were factors which moved the commercial element which characterises the activities of money lenders gener-y and conferred a benefit upon the member to whom the loan was made and in effect con-tuted a service. I would, with great respect to this judgement, consider it to be an isolated e decided upon its own set of facts and not a precedent to be relied upon, except in a case ere the facts were identical.

ving qualified as a co-operative under the provisions of Sections 117 and 118 the company entitled to a deduction of the classes of distributions referred to in Section 120. The timing such a deduction is essentially one of fact and a distribution made in a particular year of ome is a deduction in that year irrespective of whether the income from which it is dis-uted was earned in a prior year or not (See Ardmona Fruit Products Co-operative Ltd. v. leral Commissioner of Taxation (1952), 5 A.I.T.R. 342). In the case cited the company sought a deduction of a payment made to the Victorian Government in terms of Section (1) (c) some 12 months after the end of the year of income. This deduction was denied by court which at the same time indicated that the amount in question was an allowable ded-on of the subsequent year. It is understood that in practice the Commissioner of Taxation s the view that amounts paid out within a short time after the end of the year of income be treated as allowable deductions of that year of income, but a company faced with a llowance of such claims would need to keep its options open by so framing the objection ractical approaches by the Commissioner of Taxation do not necessarily decide the issue litigated case no matter how appropriate that approach may be.

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Co-operatives, in common with other types of business structures, frequently suffer from the lack of liquidity and seek deductions by way of a claim for credits allowed to shareholders which in fact do not find their way to those shareholders. One co-operative credited its shareholders with the credit balance of its profit and loss account and at the same time made a levy of the identical amount upon the shareholders, debiting the levy to their accounts. The court took the view that what was done was a mere bookkeeping device adopted because it was assumed that it would enable the company to obtain a deduction and that the company had not made a distribution which entitled it to a deduction under Section 120 (Berri Co-op Packing Union Ltd. v. Federal Commissioner of Taxation (1930), 44 C.L.R. 236). In 8 C.T.B.R. (N.S.) Case 55 the company involved credited the amount to the shareholder but under the rules of the company the shareholder was not entitled to receive payment of an amount standing to the credit of his account with the company until he withdrew from the company. In these circumstances the Board held that there had been no actual distribution and the amount credited was not an allowable deduction. The question, therefore, arises as to the way in which a company which has adequate funds but inadequate cash reserves can obtain a deduction under Section 120 without making a physical distribution of cash. Under the definition of "dividend" contained in Section 6(1) of the Income Tax Assessment Act that term includes -

> "(c) the paid up value of shares issued by a company to any of its shareholders to the extent to which the paid up value represents a capitalisation of profits".

If, therefore, a company declared a dividend out of accumulated profits and resolved that such dividend should be satisfied by the issue of shares then, in my opinion, the company has made a distribution amongst its shareholders as dividends and is entitled under Section 120 (1) (b) to a deduction of the amount of that distribution. The proposal, of course, has the disadvantage that the shareholder received a dividend which is taxable in his hands and in fact has received no cash with which to pay that tax. This is a practical problem and can perhaps be resolved in one of two ways.

1. By allowing such shareholders as are in need of the cash to pay the tax to sell their shares to other members, or alternatively,

2. To have a dividend which is satisfied as to 50% by cash and 50% by the issue of shares. The cash part of the dividend would then be available to meet the tax obligations of the shareholder.

Distributions by way of rebate or bonuses based on business done must be, in the light of the cases referred to above, in the form of cash or alternatively a credit which is available as and when required. Dividends will in all cases be taxable in the hands of the recipient while rebates and bonuses, if not related to the business activities of the shareholder, will, under most circumstances, not be subject to tax in the shareholders hands under Section 120 (2).

The third deduction to which a co-operative is entitled is that which relates to the repayment to a Government (N.B. not a Government authority) of money borrowed to acquire certain assets for the purpose of conducting a business related to the acquisition of commodities or animals from the co-operative's shareholders. This particular provision has the added test contained in the proviso to Section 120 (1) that the shares in the co-operative must be held as to 90% of the paid up capital of the company by persons supplying the company with the commodities or animals in which it deals.

Under this particular provision a co-operative failed to obtain a deduction because the moneys were borrowed from a Government instrumentality and not from the Government. In 18 C.T.B.R. (N.S.) Case 2 the co-operative had borrowed the moneys from the Commonwealth Development Bank of Australia and the Board in confirming the disallowance of the objection lodged by the taxpayer held that the Commonwealth Development Bank was not "the Government of the Commonwealth" for the purposes of Section 120 (1) (c) and accordingly the moneys when repaid were not an allowable deduction.

The foregoing comments have dealt with the interpretation of the law relating to the taxation of co-operatives up until the present time. The cases show that the tribunals adjudicating upon disputes with the Commissioner have adopted what I would call, with respect, a practical approach to the problems associated with the interpretation of this particular Division. In particular I would suggest that the tribunals have had regard to developing commercial and Government practice except in the case of moneys made available by Government authorities rather than by Governments. Such authorities are set up for the purpose of substituting for the Government in such circumstances and it would appear that whilst one cannot quarrel with the decision of the Board of Review in the case, that the case is one in which some consideration should be given to a change in the law in the light of the developing practice.

The future of the taxation of co-operatives is perhaps in the hands of the Committee presently reviewing the taxing legislation of Australia and in certain areas affecting co-operatives consideration may need to be given by that Committee to the Income Tax Assessment Act.

As most of you are aware submissions have been made by the Federation to the Committee and the Federation has indicated that it would be prepared to be represented before the Committee to support these submissions and to rebut any arguments for removal of the Division. As part of these submissions certain proposals have been made designed to overcome the effect of some of the decisions referred to in the preceding pages. An examination of the statistics available show that the majority of co-operatives are small in size, in fact of 3,623 companies assessed by the Commissioner as co-operatives for the year ended 30 June 1971, 3,219, or almost 90%, had a taxable income of less than $2,000. When one compares this figure with the average number of shareholders in co-operatives as disclosed by the Commonwealth Year Book of approximately 600, it becomes clear that they would not be an attractive investment as such and must rely for support upon the persons who in effect are the reasons for the co-operative's existence. The control exercised by statute in the various States upon the maximum dividends, the prohibitions within the Income Tax Assessment Act upon quotations of shares are things designed to remove investment in co-operatives from the investor to the person engaged in business transactions with the co-operative. Because these co-operatives are frequently engaged in business activities in areas where normal facilities are not available to the same extent as is the position in large cities they tend to develop extraneous activities such as the selling of merchandise in the area. In a case such as 8 C.T.B.R. (N.S.) Case 80 this immediately removes them from the advantage which is allowed by way of deduction for dividends paid to shareholders. Management of such co-operatives is then faced with a decision as to whether they should meet what is almost certainly a social need in the area in the form of ready access to merchandise or confine their activities to their own shareholders and leave other people in the area, possibly employees of shareholders and certainly people who will be interested in the overall business activities of the shareholders, to struggle for themselves and find a source of supply for such merchandise.

With these social difficulties in mind it was thought proper to submit that a developing "primary object" should not, at least in the initial stages, have the 90% test imposed upon the co-operative that is in line with the interpretation that has been placed on Section 118.

A further recommendation made was in connection with the procedure whereby Governments now move through Government agencies rather than directly in supporting business activities which the Government considers to be desirable. The decision of the Board of Review that the Commonwealth Development Bank was not "a Government" is one which should be adjusted by amending the law to permit a deduction for moneys paid in the specified circumstances of Section 120 (1) (c) to public authorities rather than limiting that provision to Governments simpliciter. Agencies such as the Commonwealth Development Bank do not operate within the conventional banking system and in fact, if not in law, such instrumentalities are an arm of the Government designed to operate for the advantage of Australian as a whole.

Finally, one can draw attention to the area in which Governments have intervened to impose their wills upon the operations fo co-operatives. Two particular areas come readily to mind -

1. the requirement by State statute that a proportion of profits should be placed to reserves and retained for the overall financial advantage of the co-operative, and

2. the requirement of State law that co-operatives accept the product of persons engaged in particular activities, irrespective of whether they are acceptable to the co-operative or not.

Dealing firstly with the requirement that funds be transferred to reserves for the overall financial stability of the co-operative, since such a procedure is to the advantage of the area in which the co-operative operates as a whole and certainly not to the individual advantage of the shareholders, it would seem reasonable that such statutory appropriation of funds for required reserves should be an allowable deduction in the same way as are dividends which are distributed to the shareholders of the co-operative. The logic of this proposition is clear, particularly when one has regard to the proposition that such reserves cannot be in effect realised upon by the shareholder selling his shares in the manner in which the normal investor can take advantage of the increase in retained profits in the normal commercial company.

In the second case of a statutory requirement that a co-operative accept the product of any persons seeking to supply it with a specific product, one must refer to the statutory requirement in New South Wales relating to the fishing industry. The difficulty in this particular case is to try and frame some sort of proviso which will result in a situation where such co-operatives are on a similar footing to other co-operatives. Perhaps this can be achieved by treating as the product of the co-operative's shareholders any products supplied by a shareholder in another co-operative. Once again we are dealing with a situation where statutory authority has intervened to destroy any possibility of a co-operative obtaining the advantages of Division 9 and this should properly be a matter for consideration by the Government in determining its future attitude to co-operatives.

It is clear that the existence of co-operatives throughout Australia in many cases is the result of a need in a particular area for a business structure in which the returns are not such as to be attractive to the investor seeking a return for his money. As such they need to be encouraged

to the maximum degree.

QUESTIONS TO - E.F. MANNIX

Q. K.W. Edwards - Westralian Farmers

What would be the Co-operatives tax liability in respect of distribution to members from asset revaluation?

A. In the hand of the members the distribution would be exempt from taxation but the Co-operative would be liable to pay tax as the distribution is from income other than earned income.